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Nos. 86-781 & 86-793

IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

KANSAS GAS & ELECTRIC COMPANY,
Appellant,
v.
STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS,
Appellee.

KANSAS CITY POWER & LIGHT COMPANY,
Appellant,
v.
STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS,
Appellee.

On Appeal from the Supreme Court of Kansas

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* OF THE EDISON ELECTRIC INSTITUTE

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On Appeal from the Supreme Court of Kansas

MOTION FOR LEAVE TO FILE BRIEF *AMICUS CURIAE*

Pursuant to Rules 36 and 42 of the Rules of the United States Supreme Court (the Court), the Edison Electric Institute (EEI) respectfully moves this Court for leave

to file the brief *amicus curiae* annexed hereto.[1] EEI previously submitted its Brief *Amicus Curiae* in Support of Appellants' Jurisdictional Statements pursuant to its Motion for Leave to File its Brief *Amicus Curiae* which was granted by this Court on February 23, 1987. 55 U.S.L.W. 3569 (Feb. 24, 1987).

INTEREST OF EDISON ELECTRIC INSTITUTE

The Edison Electric Institute (EEI) is the association of the nation's investor-owned electric utility companies. Its members serve 96 percent of all customers of the investor-owned segment of the electric utility industry and serve 73 percent of the nation's consumers of electricity.

The Fifth and Fourteenth Amendments' constitutional limitations on state ratemaking authority have long been etched into the law. Moreover, since decisions in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942), and *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), this Court has freed state regulatory commissions to employ whatever ratemaking methods or formulas they may choose so long as the "end result" of state rate orders meets constitutional standards requiring protection of investor interests.

Historically, the regulatory system in this country has required public utilities to plan for and provide safe and reliable service to all who seek service, both present and future, and to forego unregulated, market-based profits in provision of such service. In return, utilities tradi-

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[1] EEI has received consent for filing this brief *amicus curiae* from appellants and from Kansas Legal Services, Inc., Kansas Electric Power Cooperative, Inc., the Johnson County Joint Intervenor Group, the State Corporation Commission of the State of Kansas, the Attorney General of the State of Kansas, and the Cities of Wichita, Cheney, Clearwater, Derby, Garden Plain, Goddard, Kechi, Potwin and Whitewater, Kansas. The letters providing consent have been filed with the Clerk of the Court. Only the Alliance for Liveable Electric Rates has refused to grant consent to EEI's participation as *amicus* in this appeal.

tionally are afforded an opportunity to recover the legitimate costs of providing service, including a reasonable, but regulated return to investors. And under *Hope*, regulators have been required to protect investor interests in rates sufficient to meet the cost of service and capital obligations as a prerequisite for a finding of constitutionally just and reasonable rates.

Much has changed in the world of regulated utilities in the years since this Court first articulated the constitutional standard against which utility rate orders must be measured. The turbulent energy markets of the 1970's have produced much higher than forecasted fuel prices, which in turn have disrupted historic trends in growth of electricity demand. At the same time, construction projects undertaken to serve projected demand encountered long lead times, rapid inflation, high capital costs, and shifting regulatory requirements. These developments raised unprecedented financial and regulatory obstacles to successful completion of new power plants. As a result, capacity costs of new plants have been considerably higher than those of plants built previously by utilities. The consequent negative regulatory reaction to these projects has in some instances shaken the very foundation of the system of providing utility service.

Increasingly in recent years, and starkly illustrated in this particular appeal, courts and commissions have neglected the financial integrity of utilities while purportedly undertaking a balance of customer and investor interests under *Hope*. In doing so, these bodies have either failed to apply, or have misapplied, the constitutional doctrine. The decisions of the Kansas Corporation Commission (KCC) in this case, endorsed as they were by the Kansas Supreme Court, are an extreme example. Neither the Kansas Court nor the KCC meaningfully applied the *Hope* criteria, and neither attempted to determine the impact of the KCC's orders on investors. Yet, as the jurisdictional statements make absolutely clear, the finan-

cial consequences for appellants—and, in the long run, for their investors *and* ratepayers—are ominous.

Reaffirmation of the constitutional limits on ratemaking can wait no longer. As detailed in EEI's Brief in Support of Jurisdictional Statements, billions of dollars have been invested in nuclear generating units that are in various stages of construction or are completed awaiting final rate decisions. If regulators allow their decisions concerning utility investments to be guided by hindsight, and continue to tip the balance away from investors or, worse, ignore investor interests altogether, investors could face confiscatory disallowances of billions of dollars of prudently invested capital, representing a substantial portion of the common stock equity of companies with nuclear units. While the focus of this case is on investment in a nuclear plant, the principles at stake apply with equal force to power plants using other fuels or any other investments by electric utilities, and to the investment of other kinds of investor-owned utilities subject to ratemaking.

This appeal represents a critical juncture both for the nation's investor-owned electric utilities and for the constitutional rules fashioned by this Court. For the Fourteenth Amendment to have meaning and continuing validity as a check on state ratemaking authority, the Court must remind state regulators that the investor interest articulated by this Court in *Hope* is more than a hollow phrase.

As the national association of investor-owned electric utilities, EEI is in a position to broadly reflect the impact of the issues raised in this appeal. The attached brief *amicus curiae* addresses the constitutional issues arising in the instant case from the perspective of the many companies throughout the nation that have committed substantial investment in new generating facilities pursuant to state-mandated obligations to serve. This viewpoint should contribute to this Court's understanding of

the issues and the broad future implications of this case for the nation's electric utilities, ratepayers, and the investors who provide the capital necessary to maintain the reliability and effectiveness of the nation's electric utility systems.

CONCLUSION

For the reasons set forth above and in the attached brief, EEI urges this Court to grant its motion for leave to file the attached brief as *amicus curiae.*

Respectfully submitted,

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QUESTIONS PRESENTED

Edison Electric Institute adopts the questions presented set forth in the briefs of appellants Kansas Gas and Electric Company and Kansas City Power & Light Company.

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BRIEF *AMICUS CURIAE* OF EDISON ELECTRIC INSTITUTE IN SUPPORT OF APPELLANTS

Edison Electric Institute (EEI) submits its brief *amicus curiae* in support of appellants Kansas Gas and Electric Company (KGE) and Kansas City Power & Light Company (KCPL).

INTEREST OF EDISON ELECTRIC INSTITUTE

EEI is the national association of investor-owned electric utility companies in the United States. Its members serve 96 percent of all customers of the investor-owned segment of the industry and 73 percent of the nation's electricity users. Appellants KGE and KCPL are both EEI members.

As discussed in the Argument, decisions of this Court have long required that federal and state regulatory agencies approve public utility rates at non-confiscatory levels and ensure a balance between investor and consumer interests in the ratemaking process. Notwithstanding these decisions, the Kansas Supreme Court (Kansas Court) has affirmed orders of the State Corporation Commission of Kansas (KCC) which disallowed (for current return purposes) approximately $1.2 billion of the appellants' investment in the Wolf Creek nuclear generating station which the KCC determined was not imprudent. As demonstrated in appellants' briefs, this staggering sum consists of more than three-fourths of appellants' prudent Wolf Creek investment.

While apparently believing the disallowance benefits consumers, the KCC was in fact being shortsighted. The commission orders undermine the very basis of our regulatory system, which is designed to encourage private investment in facilities devoted to serving the public interest. The deprivation of a return on investment which is not imprudent seriously erodes the system that in shorthand form has been described as the regulatory compact, *i.e.*, the economic and regulatory relationship among investors, utilities, regulatory commissions and consumers. Furthermore, disallowances of this sort will ultimately increase the cost of capital as investors demand greater returns in response to heightened risk. These costs of doing business will, in turn, be passed through to consumers over time in higher rates for electricity.

As detailed in EEI's Brief *Amicus Curiae* in Support of the Jurisdictional Statements, disallowances of prudent utility investments could deny investors a return of, or a return on, billions of dollars of investment in electric utilities, or both. On behalf of its members, EEI has a strong interest in seeing that regulators adhere to constitutional principles in their ratemaking decisions. Otherwise, commissions, in pursuit of the near-term objective of rate suppression, may impose similar unconstitutional disallowances upon nuclear plants not yet on line, power plants using other fuels, and other utility investments subject to ratemaking. The recent U.S. Department of Energy, Energy Security Report to the President concludes that significant investment must be made in additional power plant capacity before the turn of the century. Investors will be averse to making the capital investment necessary to build this needed capacity, however, unless this Court provides state commissions with an emphatic reminder of the constitutional limits on state ratemaking authority.

SUMMARY OF ARGUMENT

The United States is fortunate in having a highly efficient and reliable system of electric generation and supply. Investor-owned electric utilities, which own 77 percent of the installed capacity and produce 78 percent of the total electric utility generation in the country, have played a dominant role in development of this system. To fulfill their legally mandated duty to provide adequate and reliable electric service at just and reasonable rates, these utilities have been able and must continue to be able to attract capital at reasonable cost. Since the inception of state commission rate regulation in the early years of this century, utilities have been able to attract the capital necessary to build generation, transmission and other facilities. The requirements of the U.S. Constitution, as interpreted by this Court and, until recent years, respected by state regulatory commissions, have provided the assurance needed by investors that the util-

ity will be guaranteed the opportunity to earn "the reasonable cost of conducting the business." *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 291 (1923) (Brandeis, J., concurring).

However, since the 1970's many of the costs incurred in providing adequate and reliable electric service have escalated at an accelerating rate for reasons beyond the utilities' control. In an effort to suppress rate increases, some state regulatory commissions during the 1980's have strained to find grounds for disallowing costs incurred in providing the electric service. But commissions err where they disallow costs prudently incurred and depart from the constitutional constraints on utility ratemaking, thus jeopardizing the financial integrity of utilities and increasing the cost of capital due to the heightened risk of investment. In the long run, the increased cost of capital must be passed on to consumers of electricity.

More than forty years have passed since this Court described the investor interests that must be served by constitutionally valid rate orders. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). Those interests must be reflected in rates set within a "zone of reasonableness." Commissions are not required by the Constitution to adopt any particular rate level, but a rate at the bottom of the zone must not be confiscatory. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942). This Court has required commissions under the *Hope* doctrine to balance investor and consumer interests and to ensure that the "end result" of rate orders is constitutionally permissible. The KCC has utterly failed to follow these requirements.

Twenty-four years ago the Kansas Supreme Court acknowledged the fundamental legal and regulatory principles which govern rate regulation. *Southwestern Bell Telephone Co. v. State Corporation Commission*, 192 Kan.

39, 386 P.2d 515 (1963). But as shown by its decision in this case, that court must be emphatically reminded of the required constitutional analysis. The court ignored the Kansas Corporation Commission's failure to assess the utilities' ability to attract capital at reasonable rates and maintain its financial integrity, given the actual return on investment allowed by the KCC orders. Under the teachings of this Court, it is not enough for the KCC to assess the asserted justifications for individual components of its rate orders while ignoring the basic constitutional issue of whether the end result of its orders reflects a reasonable balancing of investor and consumer interests that allows the utilities the opportunity to earn the reasonable cost of conducting their businesses.

If investors are to continue to finance utility investments at a reasonable cost of capital in the future, they require assurance that the utility will have a fair opportunity to earn a reasonable return on all funds prudently invested. Moreover, the end result of a rate order that allows a reasonable return on all prudent investment will be sufficient to satisfy the lower end of the zone of reasonableness and thus be constitutional. In this case, however, the KCC ignored sound legal and regulatory principles in disallowing a current return on more than three-fourths of the companies' prudent investment.

As shown by recent studies and government reports, extensive investment will be necessary in new and replacement generation and new transmission lines by the mid-1990's if electric utilities are to continue to fulfill their obligation to provide adequate and reliable electric service. Yet, if this investment is to be available at reasonable costs of capital, the historic economic and regulatory relationship among utilities, investors, regulators and consumers—referred to in more recent times as the regulatory compact—must be restored. This Court will go a long way toward restoring that relationship by emphatically reiterating the constitutional limitations on the

KCC's ratemaking authority and requiring the commission to conduct the necessary balancing of investor and consumer interests. Accordingly, this Court should instruct the Kansas Court to remand this case to the KCC for a determination of whether the rates meet the constitutional minimum of allowing the utilities to attract capital at reasonable costs and to maintain their financial integrity.

ARGUMENT

EEI fully endorses the questions presented and arguments in the briefs of appellants KGE and KCPL. These briefs demonstrate that the KCC decisions, affirmed by the Kansas Court, violated appellants' rights under the Fifth and Fourteenth Amendments to the U.S. Constitution and, as KGE shows, violated their equal protection rights. This brief will not repeat all of appellants' arguments. Rather, it will selectively focus upon arguments and policy considerations which we believe will assist the Court in its deliberations.

I. The Fourteenth Amendment Protection Against Confiscation and the *Hope* Balance of Investor and Consumer Interests Govern Commission Determinations of Rates.

A. This Court's decisions compel commissions to protect investor interests in setting rates at nonconfiscatory levels.

The principle of just compensation in rate regulation, first established in the *Railroad Commission Cases* and echoed in other decisions of this Court,[1] received recognition in the context of utility rate regulation in a line of cases extending from *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276

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[1] *See, e.g., Railroad Commission Cases*, 116 U.S. 307, 331 (1886); *Reagan v. Farmers' Loan & Trust Co.*, 154 U.S. 362, 399 (1894).

(1923),[2] to *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944). The compensation required by the Constitution in utility rate cases was articulated in Justice Brandeis' seminal concurring opinion in *Southwestern Bell* as follows:

> *The compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges.* Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital. The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more. But *a rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined.*

Id. at 291 (emphasis added).

This formulation of the constitutional standard of just compensation in utility rate regulation has been followed by the Court through the years. *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575 (1942), involved the requirement that the Commission set "just and reasonable rates" under the Natural Gas Act. The constitutional standard was important to reviewing cases governed by the Act because under the Act "the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense." *Id.* at 585. Thus, the Court found the Act's "just and reasonable" standard to "coincide" with that of the Constitution. *Id.* at 586. *Accord, In re Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968).

In *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), the Court was faced with the

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[2] *See also Bluefield Waterworks & Improvements Co. v. Public Service Commission*, 262 U.S. 679, 690 (1923).

same coincidence of the congressional standard and constitutional standard for just compensation, *i.e.*, whether rates set under the Natural Gas Act fell below the "lowest reasonable rate" allowed by the statutory standard of "just and reasonable rates." The Court set forth the investor interests that must be served by constitutionally valid rate orders as follows:

> [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is *important that there be enough revenue not only for operating expenses but also for the capital costs of doing business.* These include service on the debt and dividends on the stock. . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. *See State of Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Commission*, 262 U.S. 276, 291 . . . (Mr. Justice Brandeis concurring).

Id. at 603 (emphasis added). *Accord*, *Permian Basin*, 390 U.S. at 792 ("the court must determine whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed. . . .").[3]

Moreover, a company need not be on the verge of bankruptcy before investor interests are constitutionally protected:

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[3] In *Jersey Central Power & Light Co. v. Federal Energy Regulatory Commission*, 810 F.2d 1168 (1987), Judge Bork turned to the same formulations of the capital attraction standard and explained: "[The company] needed to record *earnings* in order to lay a foundation for the issuance of securities and regain access to the capital markets." *Id.* at 1187 (emphasis in original).

> *Hope Natural Gas* talks not of an interest in avoiding bankruptcy, but an interest in maintaining access to capital markets, the ability to pay dividends, and general financial integrity. While companies about to go bankrupt would certainly see such interests threatened, companies less imminently imperiled will sometimes be able to make that claim as well. . . . The contention that no company that is not clearly headed for bankruptcy has a judicially enforceable right to have its financial status considered when its rates are determined must be rejected.

Jersey Central Power & Light Co. v. Federal Energy Regulatory Commission, 810 F.2d 1168, 1180 (1987).

Authoritative commentators on utility rate regulation agree that capital attraction is the primary criterion governing the determination of a fair rate of return. Professor James Bonbright reasoned:

> Recalling, then, that we are concerned with the *principles* by which to measure a fair return rather than with details of application to any one case, what criteria of fairness or effectiveness should govern the choice of these principles? Among these criteria, *high place, perhaps first place, must be given to that of capital-attracting efficiency.* Judged by this test alone, choice should rest with whatever principles of rate control are best designed to permit well-managed, soundly financed public utility companies to attract needed capital.

J. Bonbright, *Principles of Public Utility Rates* 152 (1961) (footnote omitted, first emphasis in original and second emphasis added), *citing Hope*, 320 U.S. at 605. In the same vein, Professor A.J.G. Priest wrote:

> *If any one criterion is to be particularly emphasized [in determining rate of return], attraction of capital should get the nod. . . .*
>
> * * * *
>
> If the "reasonable terms" on which capital is attracted permit common stock to be issued in appro-

> priate amounts and under conditions which work no dilution in the per-share earnings of existing stockholders, the enterprise will have raised the "money necessary for the proper discharge of its public duties."

1 A. Priest, *Principles of Public Utility Regulation* 199 (1969) (footnote omitted and emphasis added).

B. In meeting the "end result" test, commissions must calculate reasonable rates which, after balancing investor and consumer interests, fall within a "zone of reasonableness."

A commission must ensure that the total impact of its rate order, however arrived at, does not have unjust or unreasonable consequences resulting in confiscation.

> Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling. . . . It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important.

Hope, 320 U.S. at 602 (citations omitted); *see also Natural Gas Pipeline*, 315 U.S. at 586.

In meeting the "end result" test, the commission must also review those rates to see if they fall within a "zone of reasonableness." "[T]here is a zone of reasonableness within which the Commission is free to fix a rate varying in amount and higher than a confiscatory rate. . . ." *Natural Gas Pipeline*, 315 U.S. at 585 (citations omitted). In addition, this Court has recognized that the ratemaking process involves a balancing of investor and consumer interests. *Hope*, 320 U.S. at 603. This balancing process can result in movement of rates up or down within the zone of reasonableness, bounded at the low

end by investor interests against confiscation and at the high end by consumer interests against exploitative rates. *Washington Gas Light Co. v. Baker*, 188 F.2d 11, 15 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951).

Thus, consumer interests may cause commissions to lower rates, investor interests may cause them to raise rates, and public interests may compel them to either lower or raise rates. *See United Gas Pipe Line Co. v. Mobile Gas Service Corp.*, 350 U.S. 332, 345 (1956); *Federal Power Commission v. Sierra Pacific Power Co.*, 350 U.S. 348, 355 (1956). Since courts do not have ratemaking expertise as commissions do, they will not second guess the methodologies used in the balancing of interests so long as the end result of the ratemaking process is not confiscatory.

That is, the cases interpreting the Constitution require that the lowest permissible rate must fall within the zone of reasonableness—and must provide the constitutionally required return—because "the 'lowest reasonable rate' is one which is not confiscatory in the constitutional sense." *Natural Gas Pipeline*, 315 U.S. at 585. Under the *Hope* doctrine, commissions must set a rate within a zone of reasonableness, but the bottom of that range, or the lowest possible rate, is one that allows the company an "opportunity to earn . . . the reasonable cost of conducting the business." *Southwestern Bell*, 262 U.S. at 291. A rate established below that level is confiscatory.

C. The Kansas Court failed to apply the appropriate constitutional standards and reverse the Kansas commission's orders.

Twenty-four years ago the Kansas Court endorsed the fundamental legal and regulatory principles (discussed above) which govern rate regulation:

> It would appear that if a utility is allowed a rate of return which will attract capital on reasonable terms, its financial integrity is fairly well assured.

> At least the two standards are closely related. The same facts and principles that establish one will tend to establish the other.

Southwestern Bell Telephone Co. v. State Corporation Commission, 192 Kan. 39, 76, 386 P.2d 515, 547 (1963). Had the Kansas Court applied the appropriate constitutional standards in this case, it would have been compelled to reverse the KCC's orders.

The Kansas Court's two-paragraph application of the legal standards (Appellants' Appendix A-45a-46a) was not only faint, but failed to undertake the necessary constitutional analysis. Nowhere did the Kansas Court discuss the financial status of the appellants. Nowhere did that court discuss the ability of the companies to attract capital or to maintain their financial integrity, given the actual return on investment allowed by the KCC orders. And nowhere did the court properly discuss whether the end result of the KCC's orders was constitutionally permissible.

In addition to the Kansas Court's failure to undertake the constitutional analysis, the KCC's application of the legal standards failed to follow the constitutional test. For example, the KCC did not avoid the infirmity described by Judge Bork in *Jersey Central*: the fact that a particular ratemaking standard may be generally permissible [4] does not *per se* legitimate the end result of the rate orders it produces. 810 F.2d at 1180. In other words, the component decisions of the rate orders aggregated together must not produce arbitrary or unreasonable consequences; the choices underlying the orders must not only be reasonable, but they must still add up

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[4] EEI agrees with appellants that the "economic valuation" methodology utilized by the KCC to deprive appellants of a current return on their investment in Wolf Creek is *not* legitimate and, furthermore, does not produce a reasonable result.

to a reasonable result. *Id.* at 1177, *citing Permian Basin*, 390 U.S. at 800; 1178.

What the KCC did was assess the alleged justifications for individual components of its rate orders while wholly avoiding the fundamental issue of whether the end result of its orders fell below the minimum level mandated by the Constitution. The KCC addressed at length the purported reasonableness of adjustments to rate base pertaining to Wolf Creek and rate of return (A-99c-110c; 133c-136c; 98f-110f; 132f-138f), but it did not address whether the return allowed by its rate orders would affect the abilities of the companies to attract capital or maintain their financial integrity, and it did not assess the financial impact of its rates on the companies. The KCC stated that the result of its orders would be "just and reasonable" (A-16d, 17g), but this bland assertion falls far short of the necessary constitutional analysis and the requirements of the *Hope* doctrine. The KCC simply did not discuss whether the end result of its orders would be constitutionally permissible.

D. A fair return on prudent investment satisfies the constitutional test and the investor component of the *Hope* balance of interests.

The KCC's orders initially disallowed 10 percent of the appellants' investment in Wolf Creek on the basis of imprudence in construction expenditures. KGE and KCPL are not contesting that disallowance before this Court.[5] However, the KCC's further decisions to disallow a current return on more than three-fourths of the companies' prudent investment in the plant are at the core of appellants' constitutional challenges. This Court

[5] This case does not involve the determination of the prudence of utility investment, but rather the exclusion of investment from rate base based on a hindsight evaluation of the results of the utility's planning decisions determined by the KCC not to be imprudent.

should strike down the KCC's decisions as a matter of law.

In his classic concurrence in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U.S. 276, 289-90 (1923), Justice Brandeis stated that the U.S. Constitution guarantees to the investors in a regulated utility the opportunty of earning a fair return on all capital that was prudently invested in it. He dismissed the "fair value" rule of *Smyth v. Ames*, 169 U.S. 466 (1898), as being legally and economically unsound, advocating in its place the prudent investment standard.

This prudent investment standard was based on a focus on the investors' "property," *i.e.*, their capital:

> The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon the *capital so invested* the Federal *Constitution guarantees to the utility the opportunity to earn a fair return.* Thus, it sets the limit to the power of the State to regulate rates. The Constitution does not guarantee to the utility the opportunity to earn a return on the value of all items of property used by the utility, or of any of them.

Id. at 290 (footnote omitted and emphasis added). *See also Pacific Gas & Electric Co. v. City of San Francisco*, 265 U.S. 403, 425 (1924) (Brandeis, J., dissenting). Justice Brandeis defined "prudent investment" to include in rate base "investments which, under ordinary circumstances, would be deemed reasonable." *Southwestern Bell*, 262 U.S. at 289 n.1. Prudent investment excludes "dishonest or obviously wasteful or imprudent expenditures." *Id.* "Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown." *Id.*[6]

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[6] For a more detailed explanation of the prudent-investment standard, see 2 J. Bonbright, *Valuation of Property* 1084-86 (1937).

The theory of prudent investment in rate base was cited with approval by three concurring justices in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 606 (1942) (Black, J., concurring). In *Hope* the Court accepted Justice Brandeis' analysis that the focus must be on the returns on investment. 320 U.S. at 603, *citing Southwestern Bell* (investor interest described as an interest in return on investment); 606 ("integrity of [utility's] investment maintained"). *See also Jersey Central*, 810 F.2d at 1181; 2 Priest, *supra*, at 497, 504. Thus, the prudent investment standard first advocated by Justice Brandeis has been acknowledged as a permissible ratemaking methodology by this Court and by a majority of the state regulatory commissions.[7] In short, the constitutional test requires an examination of and solicitude for the company's financial integrity. An examination of financial integrity in turn requires a focus on the investors' capital investment. In any particular rate case, a commission may compute the cost of service, rate base, return on rate base and, finally, rates using legitimate methodologies. In the process of determining rates, however, the constitutional ratemaking doctrine requires the commission to determine the rates' financial effects on investors and the integrity of the company. To make this determination, the agency should calculate the returns to investors on *all* the capital that was prudently invested in the utility's business.

We urge the Court to remind commissions of their obligation to make this determination in order to assess properly the effect of rates on the financial integrity of the utility. Once determined, a fair return on prudent investment will satisfy the lower end of the zone of reasonableness for the establishment of constitutional rates.

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[7] For the state commissions, see generally Rose, *The Hope Case and Public Utility Valuation in the States*," 54 COL. L. REV. 199, 212 (1954). The prudent investment standard has replaced the fair value rule in most jurisdictions.

Placing prudent investment in rate base and allowing a company's investors to earn a fair return on the original cost of the investment are a correct path for ratemaking commissions to follow. *Jersey Central*, 810 F.2d at 1181. This view is consistent with this Court's recent general discussion of the ratemaking process. *Louisiana Public Service Commission v. Federal Communications Commission*, —— U.S. ——, 106 S.Ct. 1890, 1896 (1986). In stark contrast, the KCC in this case disallowed current return on more than three-quarters of the companies' investment found by it not to be imprudent.

If a commission does not consider the need for a fair return to investors on all the capital that was prudently invested in a company, its rate determination will fail to reflect the actual effects on investors. Commissions generally seek to set allowed rates of return equal to the market cost of capital, *i.e.*, the rate of return needed to attract new capital to the company. If such a rate of return is applied to a rate base which includes less than the utility's entire prudent investment, the company will by definition earn a return *less* than the market cost of capital and will be *unable* to attract new capital on the terms found reasonable and necessary to maintain its financial integrity. This is particularly true since the utility will not be allowed to earn an unusually high rate of return on "successful investments," or to include an amount greater than its prudent investment in rate base.[8]

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[8] Dr. Alfred Kahn explained the economic principles in this fashion:

> [I]f the company makes a particularly successful investment—and there have been many such—the lion's share of the benefit goes to the consumer. . . .
>
> The other side of the bargain is, and has to be, that investors are permitted to earn that same minimum return also on the dollars that they put into investments that turn out sour. If they can earn the cost of capital only on the successes and not on the failures, it follows that they will earn less than the cost of capital on all their dollars, taken together. And investors

Furthermore, " '[p]rudent' imports the requirement that the investment, in order to gain recognition in the rate base, must have been prudently incurred in the light of foresight rather than of hindsight." Bonbright, *supra*, at 174 n.2, *citing Southwestern Bell*, 262 U.S. 276 (Brandeis, J., concurring). That is, the prudency of the investment must be evaluated as of the time of the investment, not with 20/20 second-guessing years later.

> That does not mean consumers have to bear the cost of grossly imprudent ventures; that is the justification for public utility commissions determining the prudency of utility investments. No investors can legitimately expect that. But *the only test of prudence consistent with the regulatory bargain has to be made as of the time the commitments were made.*

Kahn, *supra* (emphasis added).

Here the KCC second-guessed appellants' economic decision to build a nuclear plant instead of a coal plant or some other plant. This hindsight evaluation was imposed despite the fact that the decision to go nuclear was in accordance with national energy policies,[9] that the KCC had continually overseen the building of Wolf Creek with concurrent management prudence reviews, and that the KCC determined that the decision to build a nuclear plant was not imprudent (A-47a). In sum, the second-guessing by the KCC into the realms of alleged excess "physical" capacity and alleged excess "economic" capacity violated sound legal and regulatory principles by fail-

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won't play that game once they understand that those are going to be the rules.

Kahn, *Who Should Pay for Power-plant Duds?*, Wall St. J., Aug. 15, 1985, at 26, col. 3.

[9] *See, e.g.*, Atomic Energy Act, 42 U.S.C. §§ 2131-34, 2235 (1982); Powerplant and Industrial Fuel Use Act, 42 U.S.C. § 8311 (1982); 16 U.S.C. § 824a(g) (1982).

ing to account for the investor component of the *Hope* balance of interests.

II. Reaffirmation of the Constitutional Requirements Will Restore the Proper Relationship Among Utilities, Investors, Regulators and Consumers and Provide a Firm Foundation for the Continued Provision of Adequate and Reliable Electric Power to the Nation.

The historic relationship among utilities, investors, regulators and consumers in the provision of electric utility service in Kansas and other states throughout the nation has been characterized in more recent times as a regulatory compact. The elements of this compact, referred to at times as the regulatory bargain, are frequently embodied in state statutes. Under the compact, reciprocal obligations and benefits run to and between utility investors and companies on the one hand, and consumers of utility service on the other, with the regulatory body serving as an arbitrator balancing different elements of the public interest at stake. Utility companies, with capital supplied by investors, assume a service obligation. This obligation requires regulated utilities to furnish safe and reliable electric service to everyone desiring service, to provide service at just and reasonable rates approved by independent regulatory agencies, and to anticipate growth in demand for service and take reasonable steps in advance to meet that demand.[10]

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[10] Like most statutes providing for utility rate regulation, the Kansas Public Utilities Act has long required that electric utilities operating in Kansas furnish reliable and adequate service to existing and future customers and construct facilities for that purpose. Kan. Stat. Ann. § 66-101b (1985) (A-1j through A-2j). Despite recent amendments directed at the Wolf Creek unit, the Kansas statute still reflects in large part the implicit bargain between utility investors and consumers that underlies utility rate regulation. Public utility laws of most states impose similar obligations on utilities. 1 Priest, *supra*, at 227, 230-31. *See also* Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548, 607 (1969).

In exchange for assuming the duty to serve, investor-owned utilities generally receive a right to serve consumers within a specified geographic area. 2 A. Kahn, *The Economics of Regulation* 8 (1971). They operate as franchised monopolies, foregoing rates of return that could be obtained in the unregulated marketplace in return for the reasonable expectation that they will be allowed to earn a fair rate of return on investment and be provided some measure of protection from detrimental consequences if prudent utility investments prove unsuccessful. 1 Priest, *supra*, at 377. Until recently, the compact has operated to assure that utilities have the financial means necessary to continue to discharge the duty to serve.

Professor Alfred Kahn, a leading regulatory economist and former chairman of the New York Public Service Commission and the Civil Aeronautics Board, summarized the give and take of the regulatory bargain:

> Stockholders, protected by franchise against competition, accept the strict legal obligation to provide service to all who seek it, on just and reasonable terms. This means that they accept only reasonable profits—along with a duty conscientiously to anticipate the future needs of the public and to make whatever investments. . . . that they conscientiously judge to be necessary—in order to be in a position to meet the needs when, and if, they arise. *The government acting on behalf of consumers agrees to permit the companies to set rates sufficient to cover all costs prudently incurred in fulfilling their service obligation.*

Kahn, Prepared Direct Testimony, ACC Docket No. U1345-85-156, at 3 (Ariz. C.C. Dec. 1985) *reprinted in* J. Kalt, H. Lee, & H. Leonard, *Re-establishing the Regulatory Bargain in the Electric Utility Industry* 50 (Harvard University Energy & Environmental Policy Center

1987) (emphasis added).[11] More recently, Judge Starr offered the following description of the regulatory compact in his concurring opinion in *Jersey Central*, 810 F.2d at 1189 (citation omitted):

> The utility business represents a compact of sorts; a monopoly on service in a particular geographic area (coupled with state-conferred rights of eminent domain or condemnation) is granted to the utility in exchange for a regime of intensive regulation, including price regulation, quite alien to the free market. . . . Each party to the compact gets something in the bargain. As a general rule, utility investors are provided a level of stability in earnings and value less likely to be attained in the unregulated or moderately regulated sector; in turn, ratepayers are afforded universal, non-discriminatory service and protection from monopolistic profits through political control over an economic enterprise.

Regulatory decisions of the 1980's have badly eroded the regulatory compact. This erosion has been well documented.[12] While utilities have been and continue to be obligated to provide service to all who presently seek it and to anticipate and provide for future demand, the reciprocal element of the regulatory bargain which requires a fair return on prudent investment has been abrogated by many state commissions. Since the beginning of 1983, billions of dollars of prudent investment in operating generating capacity, most of it large nuclear

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[11] Hereinafter referred to as *Harvard Study*. A copy of this study has been lodged with the Clerk of the Court.

[12] Numerous studies and articles have detailed the breakdown of the regulatory compact and discussed the negative economic consequences of such a development on a national scale. *See, e.g.*, U.S. DEPARTMENT OF ENERGY, *Energy Security: A Report to the President of the United States* 130-31, 154-55 (1987) [hereinafter *DOE Report*; a copy of this report has been lodged with the Clerk of the Court]; *Harvard Study*; Navarro, *Our Stake in the Electric Utility's Dilemma*, HARV. BUS. REV., May-June 1982, at 87.

generating units like Wolf Creek, have been excluded from utility rate base, thereby depriving investors of an opportunity to earn a fair return.[13] In short, the breakdown of the regulatory bargain is a troubling national phenomenon.[14] *See, e.g., Jersey Central*, 810 F.2d at 1170-71. It is clearly illustrated in this case by events in Kansas. *See* KCPL Jurisdictional Statement at 3-8; KGE Jurisdictional Statement at 3-6; EEI's Brief *Amicus*

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[13] For a discussion of the extent of investors' losses, see EEI Brief *Amicus Curiae* in Support of Jurisdictional Statements at 12-15 & Appendix. Disallowance from rate base has a significant impact on investors under traditional ratemaking methodologies. Generally, "a regulated [utility] is entitled to recover its reasonable expenses and a fair return on its investment through the rates it charges customers. . . . The total amount that a [utility] is entitled to charge for services, its 'revenue requirement,' is the sum of its current operating expenses, including taxes and depreciation expenses, and a return on its investment 'rate base.'" *Louisiana Public Service*, 106 S.Ct. at 1896 (citations omitted). Through this ratemaking arrangement investors earn a return on investment only when the property in which their funds have been invested is included in the utility's rate base.

[14] Developments since the filing of EEI's Brief *Amicus Curiae* in Support of the Jurisdictional Statements offer no indication that the trend of ratemaking disallowances will abate. Other states stand poised to attempt steps similar to those taken in Kansas. For example, the Mississippi Supreme Court, saying that Mississippi ratepayers neither want nor need capacity from a new nuclear plant, has reversed a 1985 Mississippi Public Service Commission order which had granted a utility a rate increase to cover its share of the costs of the new Grand Gulf nuclear plant and directed the commission to determine whether the plant should be included in rate base. *Mississippi ex rel. Pittman v. Mississippi Public Service Commission*, No. 56,762 (Miss. Feb. 25, 1987). The Pennsylvania Public Utility Commission acted in a similar fashion recently when it voted to reconsider its decision allowing recovery of the cost of purchased power from a pumped storage unit, citing as authority the 1986 enactment of an excess capacity statute. *Pennsylvania Public Utility Commission v. West Penn Power Co.*, Docket No. R-850220, Opinion and Order upon Reconsideration (Pa. P.U.C. Apr. 17, 1987).

Curiae in Support of Jurisdictional Statements at 3-6, 15-19.

In a sense the regulatory compact has been transformed into a "heads we may break even, tails we lose" situation for investors. *DOE Report* at 155; *Harvard Study* at 57-58. The economic symmetry between risks and rewards implicit in the regulatory compact has been disregarded. Rewards earned by utility investors on successful projects remain limited, consistent with the traditional compact, as investors still are denied an opportunity to earn an unfettered, market-justified profit on the utility's successes. But the historical limitation on the downside risk of utility investment has been stripped away.

The consequent disallowances of investment in facilities deemed after the fact to be unneeded or unduly costly, which in turn preclude the utility from recovering revenues sufficient to earn its cost of capital, produce a confiscation of investors' funds. Moreover, the unfair asymmetry inherent in a regulatory system which produces virtually limitless investor risk but provides investors only with an opportunity to earn a limited return on their investment is a prescription for economic disaster. It is an unavoidable fact that utilities must obtain large amounts of capital to provide service today and into the future. Regulatory actions like those in Kansas invariably will mean that utilities, and ultimately their customers, will bear higher finance costs in order to attract necessary capital, or be denied investors' capital altogether.

Without significant additions to current generating capacity, both new capacity and replacements for existing capacity that is near the end of its useful life, a substantial likelihood exists that in some parts of the nation the electricity supply will be inadequate to meet demand by the mid-1990's. Based upon current projections of future electricity demand and the expected retire-

ments of aging power plants, the recent U.S. Department of Energy, Energy Security Report to the President has conservatively estimated that 100 gigawatts of new electric generating capacity will be needed by the year 2000. *DOE Report* at 136-41.[15] Another forecast cites the need for 150 gigawatts—roughly equal to 150 new coal or nuclear power plants. Navarro, *supra* n.12, at 88.

The current regulatory environment offers no assurance that these future requirements will be economically and adequately met. On the contrary, the current environment virtually requires utility managers to adopt a strategy of capital minimization. Rather than invest the sums necessary for large, capital intensive baseload generating plants, and expose investors to the risks of hindsight-based disallowances when those projects are completed, managers are opting for less capital intensive technology. *DOE Report* at 130, 154-55; *Harvard Study* at 60-61; Navarro, *supra* n.12, at 90-91, 93, 97. The logical consequence of this strategy is increased dependence on capacity which uses scarce and depletable oil and gas for generation. Utility management also will be reluctant to commit to build optimally-sized baseload facilities when less capital intensive, but less efficient, facilities will do. Neither of these trends bodes well for the nation.

Restoration of the fundamental relationships embodied in the regulatory compact is essential to the efficient and timely development of the nation's energy options. By reaffirming the constitutional limits on state ratemaking authority, this Court will require regulators to consider the investors' interests in the financial integrity of the utility, to make findings concerning those interests, and to protect those interests. This protection of investors will necessarily constrain regulators' ability to deny in-

[15] *See also* UTILITY DATA INSTITUTE, INC., *The Adequacy of U.S. Electricity Supply Through the Year 2000*, Mar. 1987, executive summary [hereinafter *UDI Study*]. A copy of the executive summary has been lodged with the Clerk of the Court.

vestors a fair return on a utility's prudent investment. Revitalization of constitutional ratemaking principles will compel regulators to make financially responsible rate decisions now so that utilities are able to attract the capital needed to carry out vital plant construction and continue to satisfy their service obligations.

CONCLUSION

For the foregoing reasons, *amici curiae* Edison Electric Institute respectfully urges the Court to reverse the decision of the Kansas Supreme Court and remand with instructions that the Kansas Court, in turn, remand the case to the Kansas Corporation Commission for the establishment of constitutional rates.

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